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No. 01-681

Supreme Court, U.S.
FILED
DEC 26 2001
OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

Del Commercial Properties, Inc.,
Petitioner,

v.

Commissioner of Internal Revenue.

On Petition for a Writ of Certiorari
to the United States Court of Appeals
for the District of Columbia Circuit

REPLY FOR THE PETITIONER

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December 26, 2001

WILSON-EPES PRINTING CO., INC. – (202) 789-0096 – WASHINGTON, D. C. 20001

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REPLY FOR THE PETITIONER

This case presents a question of great importance to the administration of the tax laws and to tax planning on which the circuits are split: can federal tax authorities carve out any "step" of a transaction entered into for valid commercial reasons and deny that step tax recognition if it is included to make the commercially driven transaction more tax efficient? The importance of the case is also substantially enhanced because it arises in the context of our nation's treaty commitments. This case accordingly warrants review in order to "ensure as far as possible that similarly situated taxpayers pay the same tax." *Thor Power Tool Co.* v. *Commissioner*, 439 U.S. 522, 544 (1978).

1. Citing Fifth Circuit precedent from 1961 and 1966, the Solicitor General broadly asserts that the circuits "have had no problem" in applying the step-transaction doctrine and that, given the array of factual scenarios to which that doctrine applies, "it is unlikely that additional rules could be formulated that would have sufficient breadth and specificity to supply general guidance for the lower courts." BIO 15, 16. Whatever the state of step-transaction analysis in the Deep South during the Kennedy and Johnson Administrations, the relevant point is that an array of circuits *now* regularly call attention to the fact that the doctrine is seriously confused, particularly with respect to the "business purpose" issue presented by this case.[1]

It is critical, moreover, that the question presented by this case is not only determinative of the tax treatment of

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[1] See Pet. 8, 20 (quoting *True* v. *United States*, 190 F.3d 1165, 1174 (CA10 1999) ("a recurring problem"); *Associated Wholesale Grocers* v. *United States*, 927 F.2d 1517, 1526 (CA10 1991) ("[t]he law is unclear"); *Brown* v. *United States*, 868 F.2d 859, 862 (CA6 1989) ("a recurring problem"); *Securities Indus. Ins. Co.* v. *United States*, 702 F.2d 1234, 1244 (CA5 1983) (doctrine is "enigmatic" and "abstruse – even for such an abstruse field as tax law"); *Redding* v. *Commissioner*, 630 F.2d 1169, 1175 (CA7 1980) (same)).

innumerable transactions that already have been consummated, but also is pivotal to much domestic and international tax planning. Although the Solicitor General is quite right that the step-transaction doctrine regularly arises in numerous factual scenarios – which is precisely what makes this case so important – those scenarios very often have a common element: a commercially driven transaction that includes one or more steps or intermediaries in order to make the transaction more tax efficient. The government does not dispute that, in corporate financing arrangements, it will almost always be true that the taxpayer "could have achieved its objective more directly" but included a step "for no other purpose" than to avoid tax (Pet. App. 6a). Consequently, the conflict created by the D.C. Circuit's rule slicing each transaction into discrete, tax-motivated steps and refusing tax recognition to those slices that are included solely for their tax savings poses a substantial obstacle to rational corporate tax planning and casts into doubt and confusion the tax structure of innumerable, already consummated transactions.

The D.C. Circuit's step-transaction rule is furthermore deeply flawed because, without any basis in the text of the Internal Revenue Code or U.S.-Netherlands tax treaty, it confers extraordinary discretion upon taxing authorities to cleave any otherwise legitimate transaction into distinct "steps," disallowing recognition to any steps included for tax purposes even though they comport with the Code and U.S. treaty obligations. Cf. *Gitlitz* v. *Commissioner*, 531 U.S. 206, 213 (2001) (interpreting Internal Revenue Code based on a plain reading of the statute). As the Solicitor General acknowledges, petitioner undertook the transaction in this case not to create a tax loss but for the entirely *bona fide* purpose of securing "funding to refinance and improve some of its American properties." BIO 2. The transaction was consummated only by *bona fide* entities, including Del BV, which used substantial amounts of its interest income to finance loans to other entities apart from this transaction. See

Pet. 6. The D.C. Circuit nonetheless refused to recognize Del BV's participation because it served a tax-beneficial purpose.[2]

2. The brief in opposition's argument that the D.C. Circuit's holding does not conflict with the Seventh Circuit's decision in *Northern Indiana Public Service Co.* v. *Commissioner*, 115 F.3d 506 (1997) ("*NIPSCO*") – set forth in a muddle of references and imagined conclusions unmoored from the two courts' actual holdings – is unpersuasive. The D.C. Circuit applies a categorical rule that, even in *bona fide* transactions undertaken by *bona fide* entities, "the existence of formal business activity is a given but the inquiry turns on the existence of a nontax business motive." Pet. App. 6a. As the Solicitor General acknowledges, the rule in the D.C. Circuit is that "'the absence of a nontax business purpose is fatal.'" BIO 6 (quoting Pet. App. 6a). The D.C. Circuit's rule stands in stark contrast to the Seventh Circuit's holding, which the brief in opposition acknowledges (at 9-10), that "a corporation and the form of its transactions are recognizable for tax purposes, despite any tax-avoidance motive, so long as the corporation engages in bona fide economically-based transactions." 115 F.3d at 512. Petitioner would prevail in the Seventh Circuit because Del BV engaged in numerous economically based transactions, including but not limited to the loan to petitioner, from which Del BV profited. See Pet. 6, 15 n.6.

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[2] The fact that the transaction in this case was undertaken for a *bona fide* purpose is what distinguishes it from *Winn-Dixie Stores* v. *Commissioner*, 254 F.3d 1313 (CA11 2001), *cited at* BIO 16. In *Winn-Dixie*, the Eleventh Circuit disallowed tax recognition because the "sole purpose" of the "company-owned life insurance (COLI) program" in that case "was to satisfy Winn-Dixie's 'appetite' for interest deductions." 254 F.3d at 1314. See also *id.* at 1316-17 (same). Citing its decision in *UPS* (discussed *infra* at 8-9), the Eleventh Circuit explained in *Winn-Dixie* that the case simply involved a straightforward application of the rule that "a transaction is not entitled to tax respect if it lacks economic effects or substance other than the generation of tax benefits, or if the transaction serves no business purpose." *Id.* at 1316 (emphasis added).

a. There is no merit to the Solicitor General's argument that, notwithstanding the clear conflict between the legal holdings of the D.C. and Seventh Circuits, certiorari should be denied in light of supposed factual distinctions between this case and *NIPSCO*.[3]

Although the brief in opposition repeats the D.C. Circuit's contention that *NIPSCO* involved "a 'substantially stronger' factual demonstration by the taxpayer of a business purpose in the transaction other than the avoidance of taxes" (BIO 8), the petition demolished that inaccurate characterization of *NIPSCO* (at 13-14). Petitioner detailed the unambiguous conclusions of both the Tax Court and the Seventh Circuit in *NIPSCO* that the intermediary's "'whole business purpose,'" "'only business purpose,'" and "'undisputed'" purpose in the transaction was "'to obtain a tax benefit–specifically, to avoid the thirty-percent withholding tax.'" Pet. 13-14. Thus, even if Del BV served as "a conduit for transmittal of loan payments owed to others" (BIO 10), precisely the same was true of the *NIPSCO* intermediary, which was bound to transmit the loan proceeds

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[3] The Solicitor General's entire approach in opposing certiorari in this case is flawed. The premise of the brief in opposition is essentially that, notwithstanding the step-transaction doctrine's manifest importance to the public fisc and to tax planning, that doctrine never will merit consideration by this Court until at least two circuits are coincidentally asked to address the tax treatment of the *identical* transaction and disagree on the result. If this Court were to accept that standard for granting certiorari, the obviously substantial confusion in the lower courts over the doctrine's proper application would evade review forever. As just noted, petitioner agrees with the government that courts and tax planners apply the step-transaction doctrine in innumerable contexts. The clear circuit conflict over whether a step or intermediary in a transaction will be deprived of tax recognition unless utilized for a non-tax purpose has broad application in all of those contexts and plainly merits this Court's prompt attention. This Court accordingly can and should articulate a rule of considerable "breadth and specificity [that would] supply general guidance" (BIO 16) by deciding whether the D.C. Circuit correctly holds that "the existence of a nontax business motive" (Pet. App. 6a) is the *sine qua non* for tax recognition of each step of a transaction, or whether the Seventh and Eleventh Circuits instead correctly hold that tax-motivated steps in a transaction are entitled to recognition when part of a *bona fide* transaction.

to its parent corporation and to forward the parent's payments to the Eurobond holders. See 115 F.3d at 508.

Indeed, the Solicitor General ultimately is forced to concede that, in *NIPSCO*, the taxpayer's only purpose for including the intermediary was to create a tax-free Dutch way-station for the loans the taxpayer secured from the Eurobond holders and the reciprocal payments it sent back. Thus, the brief in opposition ultimately acknowledges that, "[b]y borrowing from the Finance Subsidiary, rather than directly from the Eurobond holders, the taxpayer sought to avoid the withholding tax on interest payments made to foreign individuals and entities." BIO 9.[4]

b. The remaining factual distinctions between this case and *NIPSCO* that the Solicitor General attempts to identify are both imagined and immaterial under the Seventh Circuit's legal standard. The Seventh Circuit's test (which the petition recounted (at 11), but the brief in opposition ignores) for determining whether an intermediary's role is sufficient to trigger tax recognition is that "so long as a foreign subsidiary conducts substantive business activity–even minimal activity–the subsidiary will not be disregarded for federal tax purposes, notwithstanding the fact that *the subsidiary was created with a view to reducing taxes.*" 115 F.3d at 11 (emphasis added). Although the Solicitor General remarkably asserts that in this case Del BV "had no meaningful business activities" (BIO 5), the Tax Court specifically found that the standard imposed by the Seventh Circuit was met here – *i.e.*, that Del BV *did* engage in "minimal business activity." Pet. App. 22a-23a. Precisely the same was true in *NIPSCO*: "The record demonstrates that [the intermediary] 'was managed as a viable concern, and not as simply a lifeless façade.' [It] conducted recognizable business activity–*concededly minimal*

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[4] See also *id.* 8 (intermediary's role was merely "[t]o effectuate the borrowing"), 9 ("The function of that subsidiary was to issue notes in the Eurobond market and to lend the proceeds to the taxpayer.").

activity, but business activity nonetheless." 115 F.3d at 513 (emphasis added).

Moreover, the various indicia of "business activity" that the brief in opposition posits in an attempt to generate some factual distinction between this case and *NIPSCO* in reality show that the Seventh Circuit plainly would have afforded tax recognition to Del BV's role:

First, the basis for affording recognition to the intermediary in this case is *stronger* than in *NIPSCO* because, while in *NIPSCO* "the taxpayer formed [the] subsidiary corporation" exclusively for the lending transaction in that case (BIO 9), it is undisputed that Del BV existed prior to and independent of the loan received by petitioner, and that petitioner had no control whatsoever over Del BV's operations. Importantly, the government admitted that Del BV engaged in at least minimal business activities – and activities independent of the transaction at issue in this case – by *stipulating* in the Tax Court that it issued other loans. See Pet. 6.

Second, both the intermediary in *NIPSCO* and Del BV profited from participating in their respective financing transactions. The Solicitor General correctly points out that, in *NIPSCO*, "the Seventh Circuit noted that the Finance Subsidiary 'netted an annual $700,000 from its borrowing and lending activities' and * * * reinvested that income 'in order to generate additional interest income'" (BIO 10 (quoting 115 F.3d at 514)), but the Solicitor General ignores that the record in this case similarly established (and the government admitted) that Del BV made a substantial profit on the interest it received from petitioner (see Pet. 15 n.6). If anything, the Seventh Circuit would be *more* likely to recognize Del BV's role. Del BV's interest income was neither offset by corresponding interest expense nor remitted to the U.S. taxpayer. In *NIPSCO*, by contrast, the intermediary's interest income was largely offset by corresponding interest expense, and furthermore this narrow interest rate "spread" was

ultimately returned to the U.S. taxpayer at the close of the transaction. In addition, according to the government, the *NIPSCO* intermediary received an interest-rate "spread" solely to comply with Netherlands-Antilles tax law. See Pet. 14-15.

Third, just as the intermediary in *NIPSCO* "obtained the funds from unrelated parties on the Eurobond market" (BIO 11-12 n.3), the funds in this case similarly originated with an unrelated lender – Royal Bank. This case accordingly cannot be distinguished from *NIPSCO*, in which the Seventh Circuit noted the role of "unrelated third parties" only to contrast that case with *Aiken Industries* v. *Commissioner*, 56 T.C. 925 (1971), in which "the transactions * * * were *entirely* between related parties." *NIPSCO*, 115 F.3d at 514 (emphasis added).

Finally, two of the criteria that the Solicitor General raises in his discussion of the *UPS* case – *i.e.*, that petitioner supposedly "just as easily [could] have borrowed the money it needed directly" from the original lender (BIO 14), and that petitioner gave the original lender "a guaranty of repayment and a security interest in its real property as a condition of the issuance of the loan" (*id.*) – apply as well to the taxpayer in *NIPSCO*. See Pet. 9, 14.[5]

Because the holdings of the D.C. and Seventh Circuits squarely conflict on a question of great importance to the tax laws, and because the factual distinctions suggested by the brief in opposition are illusory, certiorari should be granted.

3. The Solicitor General's attempt to minimize the conflict between the D.C. Circuit's holding in this case and *United Parcel Service* v. *Commissioner*, 254 F.3d 1014 (CA11 2001) ("*UPS*"), is similarly unpersuasive. As noted,

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[5] Nor is there merit to the Solicitor General's argument (BIO 12 n.3) that the "significance" of *NIPSCO* is "diminished" because that case involved "portfolio interest," which is no longer subject to tax in some instances (albeit with significant exceptions). *NIPSCO*'s holding was not limited in any respect to "portfolio interest," and the conflict presented by the petition obviously involves the step-transaction doctrine in all its applications.

even with respect to *bona fide* transactions undertaken by *bona fide* entities, the D.C. Circuit deems the absence of a non-tax purpose for any given step in a transaction "fatal" as to that step. By contrast, subsequent to the D.C. Circuit's decision in this case, the Eleventh Circuit held in *UPS* that every step in a transaction is entitled to recognition so long as it "figures in a bona fide, profit-seeking business." 254 F.3d at 1019. Petitioner would prevail in the Eleventh Circuit because it is undisputed that Del BV's role in the transaction was pursuant to petitioner's *bona fide* effort to seek financing for its ongoing operations.

a. The Solicitor General notably does not dispute the clear conflict between the D.C. and Eleventh Circuits' legal holdings. Thus, the brief in opposition acknowledges *UPS*'s holding that an intermediary's role in a transaction will be respected as long as the transaction *as a whole* has real economic effects and "as long as [the intermediary] figures in a bona fide, profit-seeking business." BIO 13 (quoting 254 F.3d at 1019). The Tax Court held that the intermediary there was not entitled to tax recognition because it was included only for tax reasons, but the Eleventh Circuit squarely rejected that holding because it "would prohibit tax planning." 254 F.3d at 1019.

b. As was true with respect to the Seventh Circuit's decision in *NIPSCO*, the factual distinctions proffered by the Solicitor General lack any force and, in any event, have nothing to do with the courts of appeals' conflicting legal *tests* for whether to afford tax recognition to an intermediary's role in an otherwise valid transaction.

First, the Solicitor General contends that, rather than securing the loan from Del BV, petitioner could "just as easily have borrowed the money it needed directly from the Royal Bank." BIO 14. Of course, the intermediary in *UPS* was no more economically indispensable than Del BV was in this case. Indeed, as the BIO recounts, for many years UPS had engaged in the same transactions *without* the

intermediary. See BIO 12 ("Before 1984 (the year in issue), the taxpayer included the entire amount of [excess value charges] in its gross income and took a deduction for claims paid.").

Second, the fact that the intermediary in *UPS* "assumed the risk of damage or loss for the excess-value shipments" (BIO 14) is irrelevant. The Eleventh Circuit explicitly held decisive "the fact that" the affiliate which received the payments was "an independently taxable entity * * * not under UPS's control," "*even if we overlook the reality of the risk*," so that "UPS really did lose the stream of income it had earlier reaped from excess-value charges." *Id.* (emphasis added). So, too, in this case: Del BV is an independently taxable entity (its Dutch tax returns are part of the record), and petitioner unquestionably lost control over the income that it transferred to Del BV.

Furthermore, the Solicitor General's reliance on the "risk" in *UPS* raises a distinction without a difference because it reflects only that this case, unlike *UPS*, involves a loan rather than insurance. The relevant point is that the Eleventh Circuit looked to the insurer's "risk" for one purpose only: to determine whether the transaction as a whole involved "the creation of genuine obligations enforceable by an unrelated party." 254 F.3d at 1018. Because the loan in this case indisputably did involve real obligations enforceable by Royal Bank, the Eleventh Circuit's test would have compelled recognition of Del BV's role in the financing transaction. *Id.*

Third, the Solicitor General invokes "the fact that petitioner was required to give, and did give, the Royal Bank a guaranty of repayment and a security interest in its real property as a condition of the issuance of the loan" as proof that "the interposition of Del BV served no bona fide purpose apart from avoiding taxes." BIO 14. But in *UPS* it was equally clear – and, indeed, the Tax Court found as a fact – that the intermediary was included for "no defensible business

purpose" but, rather, with the "sole motivation [of] tax avoidance." 254 F.3d at 1017.

Because the decision below conflicts with the Eleventh Circuit's decision in *UPS* on a fundamental question of tax law, certiorari should be granted.[6]

4. Finally, the Solicitor General notably does not dispute that the significance of this case is substantially enhanced because it also involves our nation's treaty commitments: the U.S.-Netherlands treaty, like numerous other tax treaties duly negotiated by the President and ratified by the Senate (see Pet. 22-23), commits both signatories to accord tax immunity to an array of payments made between tax residents of the signatories. In the case of interest, the treaty confers unambiguous taxing authority upon the one nation whose resident is the interest recipient (the Netherlands in this case), thereby avoiding the burden of overlapping taxation by different sovereigns. The decision below abrogates that treaty obligation by interposing a domestic tax doctrine as an insuperable obstacle to the treaty's solution to the double-taxation problem, directly implicating the "large controversy * * * within the international community as to whether general domestic anti-avoidance [tax] rules are applicable in the context of a treaty" (Simone M. Huag, *The United States Policy of Stringent Anti-Treaty Shopping Provisions: A Comparative Analysis*, 29 VAND. J. TRANSNAT'L L. 191, 231-32 (1996)).

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[6] Regarding the "assignment of income" doctrine, the Solicitor General embraces the Tax Court's reasoning that petitioner's payments made directly to its Canadian affiliate (rather than to Del BV) during the latter half of the tax period demonstrate that Del BV was included in the transaction for no non-tax-related purpose. See BIO 10. That is obviously beside the point because petitioner does not here dispute that Del BV was included for the sole purpose of triggering the protections of the U.S.-Netherlands tax treaty. See Pet. 5 n.3. The Solicitor General's remaining discussion of the "assignment of income" doctrine is therefore irrelevant to the case, but in any event is erroneous for the reasons stated in the petition (at 19-20).

CONCLUSION

For the foregoing reasons, as well as those stated in the petition, certiorari should be granted.

Respectfully submitted,

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